



FISCAL YEAR 2003

MILITARY RETIREMENT FUND

AUDITED FINANCIAL STATEMENTS

December 5, 2003

DoD
MILITARY RETIREMENT FUND
FISCAL YEAR 2003
AUDITED FINANCIAL
STATEMENTS

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DoD
MILITARY RETIREMENT
FUND

MANAGEMENT'S DISCUSSION
AND ANALYSIS

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

As of September 30, 2003

Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Military Retirement Fund. Within DoD, the Office of the Under Secretary of Defense for Personnel and Readiness has as one of its missions to oversee the operations of the Military Retirement System, including the accounting, investing, and reporting of the Military Retirement Fund (the Fund). In FY 2003, the Fund paid out approximately \$35 billion in benefits to military retirees and survivors. In addition to staff members of the reporting entity and the DoD Office of the Actuary, hundreds of individuals at the DFAS Cleveland and Denver Pay Centers are involved in making the benefit payments. However, the discrete administrative costs of supporting the Fund's activities are not determinable and are therefore not reflected in the Fund's financial statements.

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost, annual payments from Treasury to amortize the unfunded liability, and investment income. During FY 2003, the Fund received \$14 billion in normal cost payments, an \$18 billion unfunded liability amortization payment, and \$10 billion in investment income, net of premium/discount amortization. No accounts of the Fund have been excluded from the Fund's financial statements.

Summary

The military retirement system applies to members of the Army, Navy, Marine Corps, and Air Force. However, most of the provisions also apply to retirement systems for members of the Coast Guard (administered by the Department of Transportation), officers of the Public Health Service (administered by the Department of Health and Human Services), and officers of the National Oceanic and Atmospheric Administration (administered by the Department of Commerce). Only those members in plans administered by the Department of Defense are included in the valuation for the Fund.

The system is a funded, noncontributory defined benefit plan that includes nondisability retired pay; disability retired pay; retired pay for reserve service; and survivor annuity programs. The Service Secretaries approve immediate nondisability retired pay at any age with credit of at least 20 years of active-duty service. Reserve retirees must be 60 years old with 20 creditable years of service before retired pay commences. There is no vesting before retirement.

There are three distinct nondisability benefit formulas related to three populations within the military retirement system. *Final pay*: Military personnel who first became members of the

Management's Discussion and Analysis

armed services before September 8, 1980, have retired pay equal to (terminal basic pay) times (a multiplier). The multiplier is equal to (2.5 percent) times (years of service) and is limited to 75 percent. *High-3*: If the retiree first became a member of the armed services on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of terminal basic pay. *Redux*: Members first entering the armed services on or after August 1, 1986, are subject to a penalty if they retire with less than 30 years of service; at age 62, their retired pay is recomputed without the penalty. The FY 2000 Defense Authorization Act provided that Redux members now have a choice of (a) receiving High-3 benefits or (b) staying under the Redux formula and receiving a lump-sum \$30,000 payment. Members make their election during the fifteenth year of service. Those who choose the lump-sum payment must remain continuously on active duty until they complete 20 years of active duty service or forfeit a portion of the \$30,000.

Retiree and survivor benefits are automatically adjusted annually to protect the purchasing power of initial retired pay. The benefits associated with members first entering the armed services before August 1, 1986, or those entering after that date but who elect to switch to the High-3 benefit formula, are adjusted annually by the percentage increase in the average Consumer Price Index (CPI). This is commonly referred to as full CPI protection. Benefits associated with members entering on or after August 1, 1986, who elect the \$30,000 payment are annually increased by the percentage change in the CPI minus 1 percent. At the military member's age 62, the benefits are restored to the amount that would have been payable had full CPI protection been in effect. This restoral is in combination with that described in the previous paragraph. However, after this restoral, partial indexing (CPI minus 1 percent) continues for life.

Nondisability Retirement From Active Service

The current system allows voluntary retirement upon completion of at least 20 years of service at any age, subject to Service Secretary approval. The military retiree receives immediate retired pay calculated as (base pay) times (a multiplier). Base pay is equal to terminal basic pay if the retiree first became a member of the armed services before September 8, 1980. It is equal to the average of the highest 36 months of basic pay for all other members. The multiplier is equal to (2.5 percent) times (years of service, rounded down to the nearest month) and is limited to 75 percent. Members first entering the armed services on or after August 1, 1986, who elect the \$30,000 and who retire with less than 30 years of service receive a temporary penalty until age 62. The penalty reduces the multiplier by one percentage point for each full year of service under 30. For example, the multiplier for a 20-year retiree would be 40 percent (50 percent minus 10 percent). At age 62, the retired pay is recomputed with the penalty removed.

In FY 2003, 1.37 million nondisability retirees from active duty were paid \$29.3 billion.

Disability Retirement

A disabled military member is entitled to disability retired pay if the member has at least 20 years of service, or the disability is at least 30 percent (under a standard schedule of rating disabilities by the Department of Veterans Affairs) and either (1) the member has eight years of service; (2) the disability results from active duty; or (3) the disability occurred in the line of duty during a time of war or national emergency or certain other time periods.

In disability retirement, the member receives retired pay equal to the larger of (1) the accrued nondisability retirement benefit, or (2) base pay multiplied by the rated percent of disability. The benefit cannot be more than 75 percent of base pay. Only the excess of (1) over (2) is subject to federal income taxes. Base pay is equal to terminal basic pay if the retiree first became a member of the armed services before September 8, 1980. If the retiree first entered the military on or after September 8, 1980, base pay is equal to the average of the highest 36 months of basic pay.

Members whose disabilities may not be permanent are placed on a temporary-disability retired list and receive disability retirement pay just as if they were permanently disabled. However, they must be physically examined every 18 months for any change in disability. A final determination must be made within five years. The temporary disability pay is calculated like the permanent disability retired pay, except that it can be no less than 50 percent of base pay.

In FY 2003, 89,000 disability retirees were paid \$1.18 billion.

Reserve Retirement

Members of the reserves may retire after 20 years of creditable service, the last eight of which must be in a reserve component. However, reserve retired pay is not payable until age 60. Retired pay is computed as (base pay) times (2.5 percent) times (years of service). If the reservist was first a member of the armed services before September 8, 1980, base pay is defined as the active duty basic pay in effect for the retiree's grade and years of service at the time that retired pay begins. If the reservist first became a member of the armed services on or after September 8, 1980, base pay is the average basic pay for the member's grade in the highest 36 months that he/she was a member of the armed services. The years of service are determined by using a point system, where 360 points convert to a year of service. Typically, a point is awarded for a day of service or drill attendance, with 15 automatic points being awarded for a year's membership in a reserve component. A creditable year of service is one in which the member earned at least 50 points. A member cannot retire with less than 20 creditable years, although points earned in non-creditable years are used in the retirement calculation.

In FY 2003, 259,000 reserve retirees were paid \$2.85 billion.

Management's Discussion and Analysis

Survivor Benefits

Legislation originating in 1953 provided optional survivor benefits. It was later referred to as the Retired Servicemen's Family Protection Plan (RSFPP). The plan proved to be expensive and inadequate since the survivor annuities were never adjusted for inflation and could not be more than 50 percent of retired pay. RSFPP was designed to be self-supporting in the sense that the present value of the reductions to retired pay equaled the present value of the survivor annuities.

On September 21, 1972, RSFPP was replaced by the Survivor Benefit Plan (SBP) for new retirees. RSFPP still covers those servicemen retired before 1972 who did not convert to the new plan and still pays survivor annuities.

Retired pay is reduced, before taxes, for the member's cost of SBP. Total SBP costs are shared by the Government and the retiree, so the reductions in retired pay are only a portion of the total cost of the SBP program.

The SBP survivor annuity is initially 55 percent of the member's base amount. The base amount is elected by the member, but cannot be less than \$300 or more than the member's full retired pay. If a penalty for service under 30 years is included in the calculation of retired pay, the maximum base amount is equal to the full retired pay without the penalty.

The spouse's annuity is considered a two-tier benefit because, at age 62, the annuity is reduced to 35 percent of the base amount. Prior to the enactment of the two-tier benefit, survivor annuities were integrated with Social Security. SBP participants and active and reserve personnel with at least 20 years of service on October 1, 1985 were grandfathered into the two-tier system. Their survivors will be given the higher of the two annuities at age 62.

During FY 1987 the SBP program's treatment of survivor remarriages changed. Prior to the change, a surviving spouse remarrying before age 60 had the survivor annuity suspended. The change lowered the age to 55. (If the remarriage ends in divorce or death, the annuity is reinstated.)

Beginning in April 1992, retirees with base amounts equal to full retired pay could also elect a supplemental annuity for their surviving spouses after age 62, in increments of 5 percent of the base amount, up to a maximum 20 percent benefit. (The cost of this supplemental SBP benefit is borne by retirees in the form of a reduction in retired pay over and above the usual 6.5 percent reduction for SBP.)

Members who die in the line of duty or after completing 20 years of service are assumed to have retired on the day they died and to have elected full SBP coverage for spouses and/or children.

SBP annuities are reduced by any VA survivor benefits and all premiums relating to the reductions are returned to the survivor. Additionally, SBP annuities are annually increased with cost-of-living adjustments (COLAs). These COLAs may be based on full or partial CPI

Management's Discussion and Analysis

increases, depending on the benefit formula covering the member. If the member dies before age 62 and the survivor is subject to partial COLAs, the survivor's annuity is increased (on the member's 62nd birthday) to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter.

For reserve retirees, the same set of retired pay reductions applies for survivor coverage after a reservist turns 60 and begins to receive retired pay. A second set of optional reductions, under the Reserve Component Survivor Benefit Plan, provides annuities to survivors of reservists who die before age 60, but after attaining 20 years of service. The added cost of this coverage is borne completely by reservists through deductions from retired pay and survivor annuities.

A paid-up provision eliminating the reduction in retired pay for premiums for SBP and RSFPP coverage is effective October 1, 2008, for participants age 70 or older whose retired pay has been reduced for 30 years or more.

In FY 2003, 267,000 surviving families were paid \$2.08 billion.

Temporary Early Retirement Authority (TERA)

The National Defense Authorization Act for FY 1993 (P.L. 102-484) grants temporary authority for the military services to offer early retirements to members with more than 15 but less than 20 years of service. The retired pay is calculated in the usual way except that there is a reduction of 1 percent for every year below 20 years of service. Part or all of this reduction can be restored at age 62 if the retired member works in a qualified public service job during the period from the date of retirement to the date on which the retiree would have completed 20 years of service. Unlike members who leave military service before 20 years with voluntary separation incentives or special separation benefits, these early retirees are treated like regular military retirees for the purposes of other retirement fringe benefits. This authority expired at the end of 2001.

As of September 30, 2003, there were 55,000 TERA retirees receiving retired pay at an annual rate of \$713 million.

Cost-of-Living Increases

All nondisability retirement, disability retirement, and most survivor annuities are adjusted annually for inflation. Cost-of-living adjustments (COLAs) are automatically scheduled to occur every 12 months, on December 1st, to be reflected in checks issued at the beginning of January.

The "full" COLA effective December 1 is computed by calculating the percentage increase in the CPI from the third quarter of the prior calendar year to the third quarter of the current calendar year. The increase is based on the Urban Wage Earner and Clerical Worker Consumer Price Index (CPI-W) and is rounded to the nearest tenth of one percent.

Management's Discussion and Analysis

The benefits of retirees (and their survivors) are increased annually with the full COLA, except for those first entering the armed services on or after August 1, 1986 electing the \$30,000. Their benefits are annually increased with a partial COLA equal to the full COLA minus 1 percent. A one-time restoral is given to a partial COLA recipient on the first day of the month after the retiree's 62nd birthday. At this time, retired pay (or the survivor benefit if the retiree is deceased) is increased to the amount that would have been payable had full COLAs been in effect. Annual partial COLAs continue after this restoral.

Relationship with VA Benefits

The Department of Veterans Affairs (VA) provides compensation for Service-connected and certain non-Service-connected disabilities. These VA benefits can be in place of (or in combination with) DoD retired pay, but they are not additive. Since VA benefits are exempt from federal income taxes, it is sometimes to the advantage of a member to elect them. The FY 2003 Defense Authorization Act repealed the offsets to DoD retired pay for certain military retirees receiving VA compensation. Since the increases in military retired pay were not paid from the Fund, there was no impact on the liability as of September 30, 2003. The FY 2004 Defense Authorization Act repealed the reductions in military retired pay for a larger group of military retirees receiving VA compensation effective January 1, 2004. Increases in military retired pay for the FY 2004 law are to be paid from the Fund and hence have an impact on the liability. This bill was not signed until after September 30, 2003, and its effects are not included in this year's financial statements. The impact on the Fund's liability will be significant.

Veterans Administration benefits also overlap survivor benefits through the Dependency and Indemnity Compensation (DIC) program. DIC is payable to survivors of veterans who die from Service-connected causes. Although an SBP annuity must be reduced by the amount of any DIC benefit, all SBP premiums relating to the reduction in benefit are returned to the survivor.

Interrelationship with Other Federal Service

For retirement purposes, no credit is given for other federal service, except where cross-service transferability is allowed. Military service is generally creditable toward the federal civilian retirement systems if military retired pay is waived. However, a deposit (equal to a percentage of post-1956 basic pay) must be made to the Civil Service Retirement Fund in order to receive credit. Military service is not generally creditable under both systems (but is for reservists and certain disability retirees).

Relationship of Retired Pay to Military Compensation

Basic pay is the only element of military compensation upon which retired pay is computed and entitlement is determined. Basic pay is the principal element of military compensation that all members receive, but it is not representative, for comparative purposes, of salary levels in the public and private sectors. Reasonable comparisons can be made to regular military compensation (RMC). RMC is the sum of (1) basic pay, (2) cash or in kind allowances (the housing allowance, which varies by grade, location, and dependency status, and a subsistence allowance) and (3) the tax advantages accruing to allowances because they are not subject to federal income tax. (The following percentages were based on the most recent available information.) Basic pay represents approximately 70 percent of RMC for all retirement eligibles. For the 20-year retiree, basic pay is approximately 68 percent of RMC. Consequently, a 20-year retiree may be entitled to 50 percent of basic pay, but only 34 percent of RMC. For a 30-year retiree, the corresponding entitlements are 75 percent of basic pay, but only 55 percent of RMC. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Social Security Benefits

Many military members and their families receive monthly benefits indexed to the CPI from Social Security. As full participants in the Social Security system, military personnel are in general entitled to the same benefits and are subject to the same eligibility criteria and rules as other employees. Details concerning the benefits are covered in other publications.

Beginning in 1946, Congress enacted a series of amendments to the Social Security Act that extended some benefits to military personnel and their survivors. These "gratuitous" benefits were reimbursed out of the general fund of the U.S. Treasury. The Servicemen's and Veterans' Survivor Benefits Act brought members of the military into the contributory Social Security system effective January 1, 1957.

For the Old Age, Survivors, and Disability Insurance (OASDI) program, military members must contribute the employee portion of the OASDI payroll tax, with the federal government contributing the matching employer contribution. Only the basic pay of a military member constitutes wages for social security purposes. One feature of OASDI unique to military personnel grants a noncontributory wage credit of (i) \$300 for each quarter between 1956 and 1978 in which such personnel received military wages and (ii) up to \$1,200 per year after 1977 (\$100 of credit for each \$300 of wages up to a maximum credit of \$1,200). The purpose of this credit is to take into account elements of compensation such as quarters and subsistence not included in wages for social security benefit calculation purposes. Under the 1983 Social Security amendments, the cost of the additional benefits resulting from the noncontributory wage credits for past service was met by a lump sum payment from general revenues, while the cost for future service will be met by payment of combined employer-employee tax on such credits as the service occurs.

Management's Discussion and Analysis

Members of the military are also required to pay the Hospital Insurance (HI) payroll tax, with the federal government contributing the matching employer contribution. Medicare eligibility occurs at age 65, or earlier if the employee is disabled.

Performance Measures

During FY 2003, the Fund made monthly disbursements to approximately two million retirees and annuitants.

While there are many ways to measure the funding progress of a pension plan, the ratio of assets in the fund to the present value of future benefits for annuitants on the roll is commonly used. Here is what this ratio has been for the last eighteen years:

- a. September 30, 2003 = .38989
- b. September 30, 2002 = .37376
- c. September 30, 2001 = .34476
- d. September 30, 2000 = .35085
- e. September 30, 1999 = .35142
- f. September 30, 1998 = .34567
- g. September 30, 1997 = .32200
- h. September 30, 1996 = .31314
- i. September 30, 1995 = .30375
- j. September 30, 1994 = .30306
- k. September 30, 1993 = .28314
- l. September 30, 1992 = .27018
- m. September 30, 1991 = .25127
- n. September 30, 1990 = .21878
- o. September 30, 1989 = .19549
- p. September 30, 1988 = .16211
- q. September 30, 1987 = .11431
- r. September 30, 1986 = .07187

The weighted average yield of the Fund on September 30, 2003, was 5.0%.

Core Performance Measures

No operating costs are calculated for the Fund.

Limitations of the Financial Statements

These financial statements have been prepared to report the financial position and results of operations for the Military Retirement Fund pursuant to the requirements of the Chief Financial Officers Act of 1990. While the statements have been prepared from the books and records of the Military Retirement Fund in accordance with the formats prescribed by the Office of Management and Budget, the statements are different from the financial statements used to monitor and control budgetary resources that are prepared from the same books and records. These statements should be read with the realization they are for a federal entity; unfunded liabilities reported in the financial statements can not be liquidated without the enactment of an appropriation; and the payment of all liabilities other than for contracts can be abrogated by DoD.

Comparative Financial Data

To comply with DoD Financial Management Regulation Volume 6B, "Form and Content of the Department of Defense Audited Financial Statements," all of the Military Retirement Fund principal statements include comparative data for FY 2002. Balances representing a 10 percent increase between fiscal years on any component of a line item are considered material and are discussed in the corresponding footnote.

Improper Payments and Information Act

The Improper Payments Information Act requires federal agencies to report payments that should not have been made or that were made in an amount different than that required by law, regulation or contract. The Office of Management and Budget Circular A-11, "Preparation, Submission and Execution of the Budget," includes provisions implementing this Act.

In accordance with these provisions, the Department of Defense is reviewing all programs and activities and identifying those which are susceptible to significant improper payments. The Department will then estimate the amount of improper payments and establish goals to reduce the amount of these payments. Programs that meet the threshold criteria established in this guidance will be reported in next year's report. Those not meeting the criteria will be tracked internally to ensure that all cost-effective measures are being taken to minimize the amount of improper payments.

Management's Discussion and Analysis

For FY 2003, the Office of Management and Budget Circular A-11 requires the Department of Defense to report improper payments for the Military Retirement Fund. The Department conducts various types of prepayment and postpayment reviews for military retirement payments. One example is that all payments more than \$9,000 made to retirees and more than \$5,500 made to annuitants are reviewed. Another example is a monthly review of the retired pay file for similar Social Security numbers to minimize duplicate payments.

The Department identified \$33.087 million of improper payments (underpayments and overpayments) for the Military Retirement Fund in FY 2003. This represents an error rate of 0.1% of the \$32.7 billion in military retirement payments made during FY 2003.

DoD
MILITARY RETIREMENT
FUND

PRINCIPAL STATEMENTS

Principal Statements

Principal Statements

**Department of Defense
DoD Military Retirement Fund
BALANCE SHEETS
As of September 30
(In Thousands)**

	<u>2003</u>	<u>2002</u>
ASSETS		
Intragovernmental:		
Fund Balances with Treasury (Note 3)	\$ 25,198	\$ 19,403
Investments (Note 4)	182,568,848	176,496,524
Total Intragovernmental Assets (Note 2)	\$ 182,594,046	\$ 176,515,927
Accounts Receivable (Note 5)	14,736	18,269
TOTAL ASSETS	\$ 182,608,782	\$ 176,534,196
LIABILITIES		
Intragovernmental:		
Other Liabilities (Notes 6 & 7)	\$ 669	\$ 232
Total Intragovernmental Liabilities	\$ 669	\$ 232
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 6 & 9)	736,061,601	726,915,398
Other Liabilities (Notes 6, 7 & 8)	2,963,217	3,135,261
TOTAL LIABILITIES	\$ 739,025,487	\$ 730,050,891
NET POSITION		
Cumulative Results of Operations	(556,416,705)	(553,516,695)
TOTAL NET POSITION	\$ (556,416,705)	\$ (553,516,695)
TOTAL LIABILITIES AND NET POSITION	\$ 182,608,782	\$ 176,534,196

The accompanying notes are an integral part of these statements.

Principal Statements

**Department of Defense
DoD Military Retirement Fund
STATEMENTS OF NET COST
For the Years Ended September 30
(In Thousands)**

	<u>2003</u>	<u>2002</u>
PROGRAM COSTS		
(Less: Intragovernmental Earned Revenue)	\$ (41,645,876)	\$ (42,380,068)
Intragovernmental Net Costs	\$ (41,645,876)	\$ (42,380,068)
Gross Costs With the Public	44,545,886	56,855,800
Net Costs With the Public	\$ 44,545,886	\$ 56,855,800
Total Net Cost	\$ 2,900,010	\$ 14,475,732
Net Cost of Operations	\$ 2,900,010	\$ 14,475,732

Additional information included in Note 10.

The accompanying notes are an integral part of these statements.

Principal Statements

**Department of Defense
DoD Military Retirement Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30
(In Thousands)**

	<u>2003</u>	<u>2002</u>
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (553,516,695) \$	(539,040,963)
Net Cost of Operations	<u>2,900,010</u>	<u>14,475,732</u>
Ending Balances	<u>\$ (556,416,705) \$</u>	<u>(553,516,695)</u>

The accompanying notes are an integral part of these statements.

Principal Statements

Department of Defense
DoD Military Retirement Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30
(In Thousands)

	<u>2003</u>	<u>2002</u>
BUDGETARY RESOURCES		
Budget Authority:		
Appropriations received	\$ 42,155,447	\$ 43,047,602
Unobligated Balance:		
Beginning of period	169,269,176	161,409,622
Total Budgetary Resources	\$ <u>211,424,623</u>	\$ <u>204,457,224</u>
STATUS OF BUDGETARY RESOURCES		
Obligations incurred:		
Direct	\$ 35,395,693	\$ 35,188,048
Unobligated balance:		
Exempt from apportionment	176,028,930	169,269,176
Total Status of Budgetary Resources	\$ <u>211,424,623</u>	\$ <u>204,457,224</u>
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS		
Obligated Balance, Net - beginning of period	\$ 3,135,082	\$ 3,006,772
Obligated Balance, Net - end of period:		
Accounts payable	\$ 2,963,018	\$ 3,135,082
Outlays:		
Disbursements	\$ 35,567,756	\$ 35,059,738
Less: Offsetting receipts	(17,928,000)	(17,047,000)
Total Outlays	\$ <u>17,639,756</u>	\$ <u>18,012,738</u>

The accompanying notes are an integral part of these statements.

Principal Statements

Department of Defense
DoD Military Retirement Fund
STATEMENTS OF FINANCING
For the Years Ended September 30
(In Thousands)

	<u>2003</u>	<u>2002</u>
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated		
Obligations incurred	\$ 35,395,693	\$ 35,188,048
Less: Offsetting receipts	(17,928,000)	(17,047,000)
Total resources used to finance activities	<u>\$ 17,467,693</u>	<u>\$ 18,141,048</u>
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS		
Total resources used to finance the net cost of operations	<u>\$ 17,467,693</u>	<u>\$ 18,141,048</u>
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Components Requiring or Generating Resources in Future Periods:		
Other	\$ 9,146,222	\$ 21,666,473
Components not Requiring or Generating Resources:		
Other	(23,713,905)	(25,331,789)
Total components of net cost of operations that will not require or generate resources in the current period	<u>\$ (14,567,683)</u>	<u>\$ (3,665,316)</u>
Net Cost of Operations	<u><u>\$ 2,900,010</u></u>	<u><u>\$ 14,475,732</u></u>

Additional information included in Note 11.

The accompanying notes are an integral part of these statements.

Principal Statements

DoD
MILITARY RETIREMENT
FUND

FOOTNOTES
TO THE
PRINCIPAL STATEMENTS

NOTES TO THE DOD MILITARY RETIREMENT FUND PRINCIPAL STATEMENTS
FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation. The Department of Defense (DoD) Military Retirement Fund was authorized by Public Law (PL) 98-94 for the accumulation of funds to finance the liabilities of the DoD under military retirement and survivor benefit programs.

These financial statements have been prepared to report the financial position and results of operations of the Military Retirement Fund, as required by the Chief Financial Officers (CFO) Act of 1990, expanded by the Government Management Reform Act (GMRA) of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the Trust Fund Accounting Division, Accounting Directorate, Defense Finance and Accounting Service, in accordance with the requirements of the Office of Management and Budget (OMB) Bulletin No. 01-09, "Form and Content of Agency Financial Statements," and accounting principles generally accepted in the United States of America. The Military Retirement Fund financial statements are prepared by the Military Retirement Fund in addition to the financial reports required pursuant to OMB directives that are used to monitor and control the Military Retirement Fund's use of budgetary resources.

A more detailed explanation of these financial statement elements is discussed in the applicable footnote.

B. Mission of the Reporting Entity. The mission of the DoD Military Retirement Fund is to accumulate funds in order to finance on an actuarially sound basis the liabilities of the DoD under military retirement and survivor benefit programs.

The asset accounts used to prepare the statements are categorized as either entity or nonentity assets, where applicable. Entity accounts consist of resources that the agency has the authority to use, or where management is legally obligated to use funds to meet entity obligations. Nonentity accounts are assets that are held by an entity, but are not available for use in the operations of the entity.

C. Appropriations and Funds. The Military Retirement Fund is a pension program established in FY 1984 by PL 98-94, for the payment of annuities and pensions to retired military personnel and their survivors. The DoD Retirement Board of Actuaries determines the contributions made to the Military Retirement Fund. The DoD contribution is a percentage of basic pay. The Department of Treasury contribution is the annual unfunded amortization payment. Excess funds from the contributions are invested and accrued interest revenue is used to cover future liabilities of the Fund.

D. Basis of Accounting. Under the authority of the CFO Act of 1990, the Federal Accounting Standards Advisory Board (FASAB) was established to recommend Federal Accounting Standards to the Secretary of the Treasury, the Director of the Office of Management and Budget (OMB) and the Comptroller General, co-principals of the Joint Financial Management Improvement Program (JFMIP). The Statements of Federal Financial Accounting Standards (SFFAS) have been issued by the Director of OMB and the Comptroller General, some of which have deferred effective dates.

In April 2000, the American Institute of Certified Public Accountants (AICPA) through Statement on Auditing Standards (SAS) No. 69, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles (GAAP) in the Auditor's Report," as amended by SAS No. 91, "Federal GAAP Hierarchy," established the following hierarchy of accounting principles for Federal government entities:

- (A) Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations plus AICPA and Financial Accounting Standards Board (FASB) pronouncements if made applicable to Federal governmental entities by a FASAB Statement or Interpretation; (B) FASAB Technical Bulletins and the following pronouncements if specifically made applicable to Federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position; (C) AICPA Accounting Standards Executive Committee (ACSEC) Practice Bulletins, if specifically made applicable to Federal governmental entities and cleared by the FASAB, and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB; and (D) Implementation guides published by the FASAB staff; and (E) Practices that are widely recognized and prevalent in the Federal government.

Footnotes

In the absence of a pronouncement covered by Federal GAAP or another source of established accounting principles, the auditor of a federal government entity may consider other accounting literature, depending on its relevance in the circumstances. When directed by OMB, through OMB Bulletin No. 01-09, generally accepted accounting principles in the United States of America serve as authoritative guidance for Federal agencies in preparing reports that are addressed within OMB Bulletin No. 01-09.

E. Revenues and Other Financing Sources. Financing sources for the Military Retirement Fund are provided primarily through monthly Military Service contributions as a percentage of base pay, an annual unfunded liability payment from the U.S. Department of Treasury, and interest earned on investments.

For financial reporting purposes, the DoD policy requires the recognition of benefit expenses in the period incurred.

F. Accounting for Intragovernmental Activities. The Military Retirement Fund purchases and redeems non-marketable market-based securities issued by the U. S. Department of Treasury, Bureau of Public Debt. Non-marketable market-based securities include Treasury bills, notes, bonds, and over-night certificates. Treasury bills are short-term securities with maturity of one year or less and are purchased at a discount. Treasury notes have a maturity of at least one year, but not more than ten, and are purchased at a discount or premium. Treasury bonds are long-term securities with maturity terms of ten years or more and are purchased at either a discount or premium.

The Military Retirement Fund records investments at market value on the trial balance in United States Standard General Ledger Account (USSGL) 1600. Discounts and premiums are recorded on the Fund's trial balances in USSGL 1611 and 1612, respectively. The Fund calculates amortization of discounts and premiums using the effective interest method and records this amortization on the trial balance in USSGL 1613.

G. Funds with the U.S. Treasury. The Military Retirement Fund's financial resources are maintained in U.S. Department of Treasury Accounts. The Defense Finance and Accounting Service (DFAS) Arlington processes all fund receipts and adjustments. DFAS-Arlington prepares monthly reports, which provide information to the U.S. Department of Treasury, by appropriation, on transfers, deposits, and collections received. The U.S. Department of Treasury then records this information to the appropriation Fund Balance with Treasury (FBWT) account maintained in the U.S. Department of Treasury system. Differences between the Military Retirement Fund recorded balance in the FBWT account and the U.S. Department of Treasury FBWT are reconciled.

H. Accounts Receivable. As presented in the Balance Sheets, accounts receivable includes accounts, claims, and refunds receivable from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by the Fund.

I. Investments in U.S. Government Securities. Intra-governmental securities represent non-marketable market-based securities issued by the U.S. Department of Treasury, Bureau of Public Debt. These securities are redeemable at market value exclusively through the U. S. Department of Treasury, Bureau of Public Debt. These non-marketable market-based Treasury securities are not traded on any securities exchange, but mirror the prices of marketable securities with similar terms. Investments are recorded at amortized cost on the Balance Sheet. Material disclosures are provided at Note 4.

J. Contingencies and Other Liabilities. Contingencies occur when DoD Military Retired Pay is offset by Department of Veterans Affairs (DVA) payments. DoD entitlements are payable to the exact date of death and DVA entitlements end in the month preceding death. The contingency becomes payable by DoD to cover retiree benefits not paid by DVA during the month of death.

K. Net Position. Changes in Net Position reflect changes in net cost of operations.

L. Comparative Data. Certain FY 2002 balances have been reclassified to conform to the FY 2003 presentation.

Footnotes

M. Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and changes therein, disclosure of contingent assets and liabilities, and the actuarial present value of accumulated plan benefits at the date of the financial statements. Actual results could differ from those estimates.

N. Actuarial Information. The DoD Military Retirement Fund financial statements present the unfunded actuarial liability determined as of the end of the fiscal year based on population information as of the beginning of the year and updated using accepted actuarial techniques. The “projected benefit obligation” method is used as required by SFFAS No. 5, “Accounting for Liabilities of the Federal Government.”

NOTE 2. ASSETS:

(\$ In Thousands)	FY03			FY02
	Nonentity	Entity	Total	Total
1. Intragovernmental Assets:				
a Fund Balance With Treasury	\$0	\$25,198	\$25,198	\$19,403
b Investments	<u>\$0</u>	<u>\$182,568,848</u>	<u>\$182,568,848</u>	<u>\$176,496,524</u>
c Total Intragovernmental Assets	\$0	\$182,594,046	\$182,594,046	\$176,515,927
2. Nonfederal Assets				
a Accounts Receivable	<u>\$669</u>	<u>\$14,067</u>	<u>\$14,736</u>	<u>\$18,269</u>
b Total Nonfederal Assets	\$669	\$14,067	\$14,736	\$18,269
3. Total Assets	<u>\$669</u>	<u>\$182,608,113</u>	<u>\$182,608,782</u>	<u>\$176,534,196</u>

4. Line 2.b, Accounts Receivable of \$669 represents “Penalties, Fines, and Administration Fees Receivable (USSGL 1360),” net of the “Allowance for Loss on Penalties, Fines, and Administration Fees (USSGL 1369),” which will be collected on behalf of U.S. Department of Treasury. This amount is also reflected in Note 6 and 7 as a custodial liability of \$669.

NOTE 3. FUND BALANCE WITH TREASURY:

(\$ In Thousands)	FY 03	FY 02
	<u>Entity Assets</u>	<u>Entity Assets</u>
1. Fund Balances:		
Fund Type		
a. Trust Funds	<u>\$25,198</u>	<u>\$19,403</u>
b. Total	<u>\$25,198</u>	<u>\$19,403</u>
2. Fund Balance Per Treasury Versus Agency:		
a. Fund Balance Per Treasury	\$25,198	\$19,403
b. Fund Balance Per Military Retirement Fund	<u>\$25,198</u>	<u>\$19,403</u>
c. Reconciling Amount	<u>\$ 0</u>	<u>\$ 0</u>

Fund Balance with Treasury (FBWT) increased from \$19,403 in FY 02 to \$25,198 in FY 03 to ensure that sufficient funds were available to cover estimated disbursements for the last business day of FY 03.

Footnotes

NOTE 4. INVESTMENTS:

(\$ In Thousands)

	FY 03				
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium)/ Discount</u>	<u>Investments Net</u>	<u>Market Value Disclosure</u>
Intra-governmental Securities:					
a. Non-Marketable, Market Based	\$191,703,332	Effective Interest	\$ (12,737,642)	\$178,965,689	\$194,400,568
b. Subtotal	<u>\$191,703,332</u>		<u>\$ (12,737,642)</u>	<u>\$178,965,689</u>	<u>\$194,400,568</u>
c. Accrued Interest Total	<u>3,603,159</u>		<u>\$ (12,737,642)</u>	<u>3,603,159</u>	<u>3,603,159</u>
	<u>\$195,306,491</u>		<u>\$ (12,737,642)</u>	<u>\$182,568,848</u>	<u>\$198,003,727</u>
Total Intra-governmental:	<u>\$195,306,491</u>		<u>\$(12,737,642)</u>	<u>\$182,568,848</u>	<u>\$198,003,727</u>
				<u>FY 02</u>	
Intra-governmental Securities:					
a. Non-Marketable, Market Based				<u>\$172,290,152</u>	<u>\$192,218,413</u>
b. Subtotal				<u>\$172,290,152</u>	<u>\$192,218,413</u>
c. Accrued Interest Total				<u>4,206,372</u>	<u>4,206,372</u>
				<u>\$176,496,524</u>	<u>\$196,424,785</u>

Investments increased from \$176,496,524 in FY 02 to \$182,568,848 in FY 03 as a result of a cumulative positive cash flow of approximately \$6,072,325.

The investments listed above are presented at Amortized Cost and Market Value as of September 30, 2003 and September 30, 2002. Listed below is the Par Value for the U.S. Department of Treasury securities referenced above.

	<u>FY 03</u>		<u>FY 02</u>
Bonds	\$ 65,344,785	Bonds	\$ 79,811,993
Notes	\$ 52,354,778	Notes	\$ 76,584,214
Nite	<u>\$ 54,662,780</u>	Nite	<u>\$ 6,000,000</u>
Total	\$172,362,343	Total	\$ 162,396,207

NOTE 5. ACCOUNTS RECEIVABLE:

(\$ In Thousands)

	<u>FY 03</u>		<u>FY 02</u>	
	<u>Gross Amount Due</u>	<u>(Allowance for Estimated Uncollectibles)</u>	<u>Net Amount Due</u>	<u>Net Amount Due</u>
1. Entity Receivables: With the Public	\$20,762	\$ (6,026)	\$14,736	\$18,269

Footnotes

2. The General Reserve Method, under which a reserve is based on age of debts and bad debt experience, is used as stated in Chapter 3, of Volume 4, Section 030212A of the DoD Financial Management Regulation to calculate an allowance percentage.
3. Accounts Receivable With the Public, USSGL 1310, represents Refunds Receivable of overpayments of benefits. For FY 02, the increase in the Allowance for Uncollectibles was \$5,592. The change in the Allowance for Estimated Uncollectibles between FY 03 and FY 02 is \$434. This change represents the differences between the end of the prior year and the amount at the end of the current year for USSGL 1319 "Allowance for Loss on Accounts Receivable," and 1369 "Allowance for Loss on Penalties, Fines, and Administrative Fees." The difference for account 1319 was \$355, and the difference for account 1369 was \$79 for FY 03.
4. Accounts Receivable decreased from \$18,269 in FY 02 to \$14,736 in FY 03 as a result of an improvement process that identified required adjustments of \$2,100.

NOTE 6. LIABILITIES NOT COVERED AND COVERED BY BUDGETARY RESOURCES:

(\$ In Thousands)	FY 03		
	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
1. Intragovernmental Liabilities:			
a. Other	<u>\$0</u>	<u>\$669</u>	<u>\$669</u>
Total Intragovernmental Liabilities	<u>\$0</u>	<u>\$669</u>	<u>\$669</u>
2. Nonfederal Liabilities:			
a. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 9)	\$176,028,930	\$560,032,671	\$736,061,601
b. Other	<u>\$2,963,018</u>	<u>\$199</u>	<u>\$2,963,217</u>
Total Nonfederal Liabilities	<u>\$178,991,948</u>	<u>\$560,032,870</u>	<u>\$739,024,818</u>
3. Total Liabilities:	<u>\$178,991,948</u>	<u>\$560,033,539</u>	<u>\$739,025,487</u>

(\$ In Thousands)	FY 02		
	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
1. Intragovernmental Liabilities:			
a. Other	<u>\$0</u>	<u>\$232</u>	<u>\$232</u>
Total Intragovernmental Liabilities	<u>\$0</u>	<u>\$232</u>	<u>\$232</u>
2. Nonfederal Liabilities:			
a. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 9)	\$169,269,176	\$557,646,222	\$726,915,398
b. Other	<u>\$3,135,082</u>	<u>\$179</u>	<u>\$3,135,261</u>
Total Nonfederal Liabilities	<u>\$172,404,258</u>	<u>\$557,646,401</u>	<u>\$730,050,659</u>
3. Total Liabilities:	<u>\$172,404,258</u>	<u>\$557,646,633</u>	<u>\$730,050,891</u>

Footnotes

For FY 03 and FY 02, Line 1.a., Other Intra-governmental liability of \$669 and \$232, respectively, represents a custodial liability. This liability is an obligation to transfer the nonentity asset presented in Note 2. to the U.S. Department of Treasury. The nonentity asset replaces the budgetary resource to cover the liability. The change in other intra-governmental liabilities and other non-federal liabilities are explained in further details in Note 7.

NOTE 7 . OTHER LIABILITIES:

(\$ In Thousands)	<u>FY 03</u>	<u>FY 02</u>
1. Intragovernmental:		
a. Other Liabilities	<u>\$669</u>	<u>\$232</u>
Total Intragovernmental Other Liabilities	<u><u>\$669</u></u>	<u><u>\$232</u></u>
2. Nonfederal: (Note 8)		
a. Accrued Funded Payroll and Benefits	\$2,963,018	\$3,135,082
b. Other Liabilities	<u>\$199</u>	<u>\$179</u>
c. Total Nonfederal Other Liabilities	<u><u>\$2,963,217</u></u>	<u><u>\$3,135,261</u></u>
3. Total Other Liabilities	<u><u>\$2,963,886</u></u>	<u><u>\$3,135,493</u></u>
4. Other Information Pertaining to Other Liabilities:		

Line 1.A, Other Intra-governmental Liabilities of \$669 for FY03 represents a custodial liability. This liability is an obligation to transfer the nonentity asset presented in Note 2 to the U.S. Department of Treasury.

As a result of the improvement process for Accounts Receivable,” Penalties, Fines, and Administrative Fees Receivable” increased from \$232 in FY 02 to \$669 in FY03. As referenced above, the “Penalties, Fines, and Administrative Fees Receivable” are collected on behalf of the U.S. Department of Treasury, therefore, as the receivable amount increases so does the custodial liability.

NOTE 8. COMMITMENTS AND CONTINGENCIES:

Disclosures Related to Commitments and Contingencies:

(\$ In Thousands)	<u>FY 03</u>	<u>FY 02</u>
1. Other Liabilities Covered by Budgetary Resources:		
With the Public:	<u>\$2,963,018</u>	<u>\$3,135,082</u>
Total:	<u><u>\$2,963,018</u></u>	<u><u>\$3,135,082</u></u>
2. Other Liabilities Not Covered by Budgetary Resources:		
With the Public		
Death Payment Contingencies	<u>\$199</u>	<u>\$179</u>
Total:	<u><u>\$199</u></u>	<u><u>\$179</u></u>
Other Liabilities Total:	<u><u>\$2,963,217</u></u>	<u><u>\$3,135,261</u></u>

Footnotes

NOTE 10. FOOTNOTE DISCLOSURES RELATED TO THE STATEMENTS OF NET COST:

(\$ In Thousands)	<u>FY 03</u>	<u>FY 02</u>
Earned Revenue for Program Costs:		
1. Service Contributions as a Percentage of Base Pay	\$ 13,719,439	\$12,935,341
2. Annual Unfunded Liability Payment	17,928,000	17,047,000
3. Interest on Investments	9,998,336	12,397,727
4. Transfers	101	0
Total	<u>\$41,645,876</u>	<u>\$42,380,068</u>

Line 4, Transfers of \$101 for FY 03, represent a one-time payment from the Office of Personnel Management (OPM) to fund the benefits of one retired military judge.

Interest on investments decreased from \$12,397,727 in FY 02 to \$9,998,336 due to the maturities of securities that were purchased with higher coupon rates. These funds were re-invested at a lower coupon rate resulting in less interest earned.

Gross Costs With the Public decreased from \$56,855,800 in FY 02 to \$44,545,886 in FY 03 principally due to the reduction in the change in actuarial liability that was \$21,666,453 in FY 02 and is \$9,146,203 in FY 03. Due to this decrease in the change in actuarial liability the Net Cost of operations also decreased respectively.

NOTE 10A: BENEFIT PROGRAM EXPENSE:

(\$ In Thousands)	<u>FY 03</u>	<u>FY 02</u>
1. Service Cost	\$13,719,438	\$12,935,341
2. Period Interest on the Benefit Liability	44,755,214	43,393,208
3. Prior (or past) Service Cost	880,298	5,563,539
4. Period Actuarial (Gains) or Losses	<u>(14,491,980)</u>	<u>(5,037,833)</u>
5. Total Benefit Program Expense	<u>\$44,862,970</u>	<u>\$56,854,255</u>

The benefit program expenses provide components of the change in the actuarial liability from September 30, 2002 to September 30, 2003. The September 30, 2003, actuarial liability is calculated using the components of benefit program expenses as well as the expected benefit payments during FY 2003. The use of expected benefit payments is a change from prior years' methodology, which used actual benefit payments. Expected benefit payments are used in order to be consistent with the projected benefit stream used in developing the beginning of year liability. The September 30, 2003, actuarial liability is equal to the September 30, 2002, liability plus the total benefit program expenses minus the expected benefit payments.

NOTE 11. FOOTNOTE DISCLOSURES RELATED TO THE STATEMENT OF FINANCING:

(\$ In Thousands)

“Other Components not Requiring or Generating Resources” of \$23,713,905 for FY 03 represents \$9,998,336 of “Interest Revenue,” \$13,719,539 of “Benefit Program Revenue,” less \$355 of “Bad Debt Expense” and \$3,615 of “Other Expenses not Requiring Budgetary Resources.”

The FY 03 amount of \$355 represents bad debts uncollectible on accounts receivable from military retirees and survivors. The amount of bad debts uncollectible for FY 02 totaled \$399. The FY 03 calculation for the allowance for bad debts uncollectible is discussed in Note 5.

Account 6790, “Other Expenses not Requiring Budgetary Resources,” is a non-budgetary expense account created when over-payments of benefits are made to military retirees and survivors. The \$3,615 amount recorded in account 6790 is the difference between USSGL 1310, “Accounts Receivable,” at the end of the prior year and at the end of the current year. A review of USSGL 6790 is conducted to determine what portion of the account is uncollectible from the military retirees and survivors. The uncollectible amount is written off to USSGL 1319, Allowance for Bad Debts.

The statement of financing was expanded to further articulate and detail the relationship between net obligations from budgetary accounting and net cost of operation from proprietary accounting. Some items that were reported last year on a single line were subdivided to reflect its components as defined in OMB Bulletin 01-09 and U.S. Treasury Financial Manual. This change notes key differences between the net obligations and net cost of operations.

NOTE 12: OTHER DISCLOSURES:

Net Pension Expense: The net pension expense for the actuarial accrued liability is developed in the table below.

(\$ In Thousands)	<u>FY 03</u>	<u>FY 02</u>
A. Beginning of Year Accrued Liability	\$726,915,398	\$705,248,945
B. Normal Cost Liability	13,719,439	12,935,341
C. Plan Amendment Liability	880,298	5,563,539
D. Assumption Change Liability	(4,626,303)	(2,334,385)
E. Benefit Outlays	(35,716,768)	(35,187,802)
F. Interest on Pension Liability	44,755,214	43,393,208
G. Actuarial Loss (Gain)	<u>(9,865,677)</u>	<u>(2,703,448)</u>
H. End-of-Year Accrued Liability (A+B+C+D+E+F+G)	<u>\$736,061,601</u>	<u>\$726,915,398</u>
I. Net Change in Actuarial Liabilities (B+C+D+E+F+G)	<u>\$9,146,203</u>	<u>\$21,666,453</u>

Other Information:

Each year the Accrued Liability is expected to increase with the normal cost, decrease with benefit outlays, and increase with the interest cost. In the absence of (1) actuarial gains and losses, (2) plan benefit changes, and (3) assumption changes, an increase of \$22.758 billion in the Accrued Liability was expected during FY 03.

The September 30, 2003, Accrued Liability includes changes due to (1) assumptions, (2) benefit changes, and (3) experience. The new assumptions include (a) permanent disability retiree death and other loss rates, (b) updates and enhancements to the survivor valuation model, (c) first-year retiree offset factors, and (d) a new long-term salary increase assumption of 3.75 percent.

Footnotes

The combined effect of the actuarial assumption changes is an decrease in the September 30, 2003, Accrued Liability of \$4.626 billion, shown in Line D. The change in retirement benefits for FY 2003 includes the reform of basic pay rates mandated by the FY 2003 DoD Authorization Act. The effect of the benefit change is an increase in the September 30, 2003, Accrued Liability of \$0.880 billion, shown on Line C. The decrease in Accrued Liability due to the net experience gain of \$9.866 billion, shown on line G, reflects the new population on which the September 30, 2002, roll-forward is based, as well as other economic experience being different than previously assumed.

The September 30, 2002, Accrued Liability includes changes due to (1) new demographic assumptions, (2) benefit changes, and (3) an experience gain. The new assumptions include changes in (a) nondisability retiree death and other loss rates, (b) retired pay adjustment factors, (c) first-year partial pay and benefit factors, and (d) enhancements to the reserve valuation model.

Changes in retirement benefits for FY 2002 are (a) reform of basic pay rates mandated by the FY 2002 DoD Authorization Act, and (b) giving the Survivor Benefit Plan (SBP) benefit for survivors of members who die on active duty with less than 20 years of service. The combined effect of the benefit changes is an increase in the September 30, 2002, Accrued Liability of \$5.564 billion, shown in Line C. The combined effect of the actuarial assumption changes is a decrease in the September 30, 2002, Accrued Liability of \$2.334 billion, shown in Line D. The decrease in Accrued Liability due to the net experience gain of \$2.703 billion, shown in Line G, reflects primarily the new population on which the September 30, 2001, roll forward is based.

DoD
MILITARY RETIREMENT
FUND

Required
Supplementary
Information

Required Supplementary Information

**DoD
Military Retirement Fund
Intragovernmental Transactions
For the Year Ended September 30, 2003**

(\$ In Thousands)

Schedule, Part A Intragovernmental Asset Balances Which Reflect Entity Amount with Other Federal Agencies	Treasury Index	Fund Balance with Treasury	Investments
Department of the Treasury	20	<u>\$25,198</u>	<u>\$182,568,848</u>
Total		<u>\$25,198</u>	<u>\$182,568,848</u>
Schedule, Part B Intragovernmental Liability Balances Which Reflect Entity Amount with Other Federal Agencies	Treasury Index		Other
Department of the Treasury	20		<u>\$669</u>
Total			<u>\$669</u>
Schedule, Part C DoD Intragovernmental Revenues and Related Costs with Other Federal Agencies	Treasury Index		Earned Revenue
Department of the Treasury	20		\$9,998,336
Department of the Navy	17		\$4,607,789
Department of the Army	21		\$5,340,454
Department of the Air Force	57		\$3,771,196
Office of Personnel Management	24		\$ 101
Other Defense Organizations	97		<u>\$17,928,000</u>
Total			<u>\$41,645,876</u>

DoD
MILITARY RETIREMENT
FUND

OTHER ACCOMPANYING
INFORMATION

Other Accompanying Information

Other Accompanying Information

TABLE 1

MILITARY RETIREMENT SYSTEM
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2003 AND 2002
(\$ in 000s)

	<u>September 30, 2003</u>	<u>September 30, 2002</u>
1. Present value of future benefits		
a. Annuitants now on roll	\$451,482,384	\$452,876,556
b. Non-retired reservists	\$93,461,965	\$91,236,842
c. Active duty personnel ¹	<u>\$285,743,304</u>	<u>\$270,055,912</u>
d. Total	\$830,687,653	\$814,169,310
2. Present value of future normal cost contributions	\$94,626,052	\$87,253,911
3. Actuarial accrued liability	\$736,061,601	\$726,915,398
4. Assets ²	\$176,028,930	\$169,269,176
5. Unfunded accrued liability	\$560,032,671	\$557,646,222

¹ The future benefits of active duty personnel who are projected to retire as reservists are counted on line 1-b.

² The assets available to pay benefits are determined using the amortized cost method (book value) of valuation.

Other Accompanying Information

DoD
MILITARY RETIREMENT
FUND

INDEPENDENT AUDITORS'
REPORTS

Independent Auditors' Reports



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

December 15, 2003

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER
UNDER SECRETARY OF DEFENSE (PERSONNEL AND
READINESS)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Endorsement of the Unqualified Opinion on the FY 2003 Military
Retirement Fund Financial Statements (Project No. D2003FH-0124.000)

In accordance with the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, the Office of the Inspector General (OIG) of the Department of Defense is responsible for auditing the Military Retirement Fund (MRF) Financial Statements. For FY 2002, we exercised our last of four contract options with Deloitte & Touche LLP to audit the MRF Financial Statements. A new competitive contract was issued to Deloitte & Touche LLP for the FY 2003 to FY 2007 MRF Financial Statements.

Unqualified Audit Opinion. We concur with the Deloitte & Touche LLP unqualified opinion, dated December 5, 2003. Deloitte & Touche LLP opined that the FY 2003 MRF Financial Statements and accompanying notes present fairly, in all material respects, the MRF financial position as of September 30, 2003, and its net cost, changes in net position, budgetary resources, and reconciliation of budgetary resources to net cost for the year then ended. The Defense Finance and Accounting Service prepared the financial statements in conformity with accounting principles generally accepted in the United States.

We concur with the Deloitte & Touche LLP report on internal control over financial reporting in connection with the audit of the FY 2003 MRF Financial Statements. The report referred to a matter involving the internal control over financial reporting that is considered to be a reportable condition. The report concluded that the general controls over electronic data processing (EDP) at the computer processing locations the MRF uses do not support the reliable processing of financial information within the related business cycles. The review disclosed deficiencies in the design or operation of controls related to EDP security policies, procedures, configurations, business continuity arrangements, and system software support activities that could adversely affect the Fund's ability to record, process, and summarize its financial information in accordance with all appropriate requirements.

This was a reportable condition that Deloitte & Touche LLP believed was not material for financial statement purposes. However, this condition could be considered significant in the context of a material weakness for DoD information security purposes.

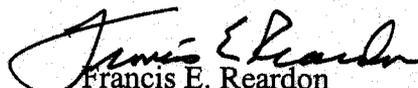
As part of this audit, Deloitte & Touche LLP had to obtain reasonable assurance that the FY 2003 MRF Financial Statements are free of material misstatement. Deloitte & Touche LLP performed tests of the compliance of the administration of the MRF with certain provisions of law and regulations. Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," requires that test results be reported if noncompliance with certain other laws and regulations occurs. Specifically, the noncompliance concerns are the following.

- MRF data is processed on electronic data processing systems that are not fully compliant with OMB Circular A-127, "Financial Management Systems."
- The MRF uses a general ledger system that is not transaction based or derived from an integrated financial system.

Audit Responsibilities. We are responsible for obtaining reasonable assurance about whether the principal statements are fairly presented and free of material misstatement, in conformity with accounting principles generally accepted in the United States.

To fulfill our oversight responsibilities, for the contract with Deloitte & Touche LLP, we complied with government auditing standards; OMB Bulletin No. 01-02; and the General Accounting Office/President's Council on Integrity and Efficiency, "Financial Audit Manual," July 2001. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; met with partners and staff members of the CPA firm; evaluated the key judgments; met with officials of the MRF; performed independent tests of the accounting records; and performed other procedures appropriate to the circumstances.

We appreciate the courtesies extended to the audit team. Questions should be directed to Mr. David F. Vincent at (703) 604-9109 (DSN 664-9109) or Mr. Thomas J. Winter at (703) 604-9134 (DSN 664-9134).


Francis E. Reardon
Deputy Inspector General
For Auditing



INDEPENDENT AUDITORS' REPORT

To the Inspector General of the
Department of Defense

We have audited the accompanying balance sheets of the Department of Defense ("DoD") Military Retirement Fund (the "Fund") as of September 30, 2003 and 2002, and the related statements of net cost, changes in net position, budgetary resources, and financing for the years then ended. These financial statements are the responsibility of the management of the Fund. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget ("OMB") Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the DoD Military Retirement Fund as of September 30, 2003 and 2002, and its net cost, changes in net position, budgetary resources and reconciliation of budgetary resources to net cost for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying required supplementary information included in the sections entitled "Management's Discussion & Analysis," "Required Supplementary Information," and "Other Accompanying Information," are not required parts of the basic financial statements but are supplementary information required by OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements* and the Federal Accounting Standards Advisory Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

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To the Inspector General of the
Department of Defense

In accordance with *Government Auditing Standards*, we have also issued our report dated December 5, 2003 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

December 5, 2003



INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Inspector General of the
Department of Defense

We have audited the financial statements of the Department of Defense ("DoD") Military Retirement Fund (the "Fund") as of and for the year ended September 30, 2003, and have issued our report thereon dated December 5, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget ("OMB") Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operations of the internal control over financial reporting that, in our judgment, could adversely affect the Fund's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described below is not a material weakness.

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To the Inspector General of the
Department of Defense

1. Certain general electronic data processing (EDP) controls at certain computer processing locations used by the Fund do not support the reliable processing of financial information within the related business cycles. Our review disclosed deficiencies in the design or operation of controls related to EDP security configurations, business continuity arrangements, and system software support activities that could adversely affect the Fund's ability to record, process, and summarize its financial information in accordance with all appropriate requirements. Because disclosure of detailed information about EDP weaknesses may further compromise controls, we are providing no further details here. Instead the specifics will be presented in a separate, limited distribution management letter.

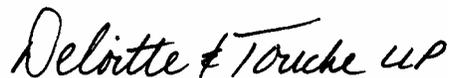
Compliance

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we perform tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02. However, providing an opinion on compliance with those provisions is not an objective of our audit and, accordingly, we will not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and that are described below.

1. The EDP systems utilized by the Fund are not compliant with OMB Circular A-127, *Financial Management Systems*. The Circular requires that federal financial systems provide complete, reliable, consistent and useful information on a timely basis. Our procedures identified deficiencies in the design and operation of certain EDP controls that may increase the risk of unauthorized access, modification, or loss of sensitive programs and data which could compromise the ability of the systems to provide reliable financial data.
2. While the general ledger system utilized by the Fund is compliant with the United States Standard General Ledger (SGL), it is not transaction based or derived from an integrated financial system.

Distribution

This report is intended solely for the information and use of the Inspector General of the Department of Defense, the Audit Committee and management of the Fund, other Defense Organizations, the Office of Management and Budget, the General Accounting Office, and the United States Congress and is not intended to be and should not be used by anyone other than these specified parties.



December 5, 2003